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In the Supreme Court of the United States

OCTOBER TERM, 1958

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

JOHN R. HANSEN AND SHIRLEY G. HANSEN

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 65-68) is not officially reported. The opinion of the Court of Appeals (Appendix A, *infra*, pp. 9-20) is not yet reported.

JURISDICTION

The judgment of the Court of Appeals was entered on August 4, 1958. (Appendix A, *infra*, p. 20.) The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether an accrual-basis taxpayer who sells property and receives part of his gain on the sale in cash and part in the form of a credit—the latter portion to be ultimately satisfied either by payment in cash or by offset against the taxpayer's obligations—is required to report the amount of gain so credited (as well as the gain in cash) as income for the year in which the credit is made.

STATUTE AND OTHER AUTHORITY INVOLVED

The statutory provisions involved are Sections 22(a), 41, and 42 of the Internal Revenue Code of 1939. Those sections, together with Rev. Rul. 57-2, 1957-1 Int. Rev. Bull. 17, are set forth in Appendix B, *infra*, pp. 21-25.

STATEMENT

During 1951, 1952, and 1953, taxpayer John R. Hansen was engaged in the business of selling automobiles at retail, under conditional sales contracts providing for payment of the purchase price in installments. The form of contract used, which was provided by the General Motors Acceptance Corporation (GMAC), called for a "Total Time Price" for the automobile sold, computed by subtracting the down payment (including the trade-in, if any) from the "Cash Sale Delivered Price", and adding to the difference the cost of insurance and finance charges. The amount thus arrived at was called the "Time (Deferred) Balance." The down payment was added back to the "Time (Deferred) Balance" to fix the "Total Time Price." (R. 61.)

Taxpayer financed all of the conditional sales during the taxable years through GMAC. He assigned each

contract pursuant to the terms of the endorsement contained thereon,[1] in exchange for the amount set forth in the contract, but reduced by an amount withheld and placed by GMAC in a reserve account. Taxpayer was not required to assign any of the contracts to GMAC or to any other finance company, and could have held such contracts himself without assignment. (R. 63.)

Under the reserve account maintained between taxpayer and GMAC, at least 5% of the outstanding balances of the contracts assigned to GMAC were retained

[1] The form contract included the following endorsement, executed by taxpayer upon assignment (Stip. Ex. 5-E; R. 6, 39-40, 62-63):

> For value received, undersigned does hereby sell, assign and transfer to the General Motors Acceptance Corporation his, its or their right, title and interest in and to the within contract, herewith submitted for purchase by it, and the property covered thereby and authorizes said General Motors Acceptance Corporation to do every act and thing necessary to collect and discharge the same.
>
> The undersigned certifies that said contract arose from the sale of the within described property, warranting that title to said property was at time of sale and is now vested in the undersigned free of all liens and encumbrances; that said property is as represented to the purchaser of said property by the undersigned and that statements made by the purchaser of said property on the statement form attached hereto are true to the best of the knowledge and belief of the undersigned.
>
> In consideration of your purchase of the within contract, undersigned guarantees payment of the full amount remaining unpaid hereon, and covenants if default be made in payment of any instalment herein to pay the full amount then unpaid to General Motors Acceptance Corporation upon demand, except as otherwise provided by the terms of the present General Motors Acceptance Corporation Retail Plan. Liability of the undersigned shall not be affected by any indulgence, compromise, settlement, extensions or variation of terms of the within contract effected with, or by the discharge or release of the obligation of the purchaser or any other person interested, by operation of law or otherwise. Undersigned waives notice of acceptance of this guaranty and notices of non-payment and non-performance.

by it. The reserve was maintained in order to protect GMAC against any loss arising from the repossession of automobiles in the event of default in payment. Also, in the event of prepayments by the purchasers of automobiles, the proportionate reduction in finance charges was charged to the reserve. (R. 63-64.)

Taxpayer's books of account and income tax returns were maintained and filed on the accrual method of accounting. In reporting income and maintaining his accounts, taxpayer debited the amounts placed in the reserve to an account entitled "Due Finance Company", and credited an account entitled "Reserve for Repossession." He did not report, in his income tax returns for 1951 and 1953, any of the amounts which were withheld by GMAC in the reserve account.[2] He did report the amounts retained in the reserve account as income in the years when such amounts were paid to him by GMAC. (R. 64.)

The Tax Court sustained the Commissioner's deficiency determination, holding that the amounts credited to the dealer's reserve account were accruable as income in the years in which they were credited to that account. (R. 64-65.) The Court of Appeals reversed the Tax Court's decision with respect to that issue. (Appendix A, *infra*.)

REASONS FOR GRANTING THE WRIT

1. The decision below, which involves an important issue as to the accruability of income for tax purposes, is in direct conflict with the decision of the Sixth

[2] Taxpayer did report, in his 1952 return, the amount of $4,462.27 which was withheld by GMAC in the reserve account. He included the same amount in 1953 income, necessitating an adjustment of income for that year. (R. 72.)

Circuit in *Schaeffer* v. *Commissioner*, decided August 20, 1958 (Appendix C, *infra*, pp. 26-34), and of the Seventh Circuit in *Baird* v. *Commissioner*, decided June 20, 1958 (1 A.F.T.R. 2d 58-2014) (Appendix C, *infra*, pp. 35-49).[3] There are no material factual differences in the cases, and the issue posed in all three is precisely the same.

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[3] The Fourth, Fifth and Eighth Circuits are in accord with the decision below. See *Johnson* v. *Commissioner*, 233 F. 2d 952 (C.A. 4th); *Texas Trailercoach, Inc.* v. *Commissioner*, 251 F. 2d 395 (C.A. 5th); and *Glover* v. *Commissioner*, 253 F. 2d 735 (C.A. 8th), in which the Government is also filing a petition for certiorari.

The Tax Court, over a period of seventeen years, has regularly sustained the Commissioner's position. *Shoemaker-Nash, Inc.* v. *Commissioner*, 41 B.T.A. 417; *Colorado Motor Car Co.* v. *Commissioner*, decided March 25, 1940 (1940 P-H B.T.A. Memorandum Decisions, par. 40,178); *Royal Motors, Inc.* v. *Commissioner*, decided July 12, 1945 (1945 P-H T.C. Memorandum Decisions, par. 45,255; *Town Motors, Inc.* v. *Commissioner*, decided July 24, 1946 (1946 P-H T.C. Memorandum Decisions, par. 46,173); *Ray Woods Used Cars, Inc.* v. *Commissioner*, decided September 30, 1952 (1952 P-H T.C. Memorandum Decisions, par. 52,290); *Central Motors, Inc.* v. *Commissioner*, decided August 12, 1954 (1954 P-H T.C. Memorandum Decisions, par. 54,228); *Blaine Johnson* v. *Commissioner*, 25 T.C. 123, reversed, 233 F. 2d 952 (C.A. 4th); *Wm. Koch Motors, Inc.* v. *Commissioner*, decided December 30, 1955 (1955 P-H T.C. Memorandum Decisions, par. 55,334); *Brodsky* v. *Commissioner*, 27 T.C. 216; *Texas Trailercoach, Inc.* v. *Commissioner*, 27 T.C. 575, reversed, 251 F. 2d 395 (C.A. 5th); *West Pontiac, Inc.* v. *Commissioner*, 27 T.C. 749, reversed, February 6, 1958 (C.A. 5th) (1 A.F.T.R. 2d 58-839); *Glover* v. *Commissioner*, decided March 18, 1957 (1957 P-H Memorandum Decisions, par. 57,045), reversed, 253 F. 2d 735 (C.A. 8th); *Schaeffer* v. *Commissioner*, decided April 30, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,068), affirmed August 20, 1958 (C.A. 6th) (Appendix C, *infra*, pp. 26-34); *Baird* v. *Commissioner*, decided October 9, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,192), affirmed June 20, 1958 (C.A. 7th) (1 A.F.T.R. 2d 58-2014) (Appendix C, *infra*, pp. 35-49); *Kilborn* v. *Commissioner*, 29 T.C. 102, pending on appeal to the Fifth Circuit; *Arthur V. Morgan* v. *Commissioner*, 29 T.C. 63, now pending on appeal to the Ninth Circuit; *Evans Motor Co.* v. *Commissioner*, 29 T.C. 555.

Although the decision below ostensibly rests upon an analysis of each automobile sale and financing arrangement as involving one indivisible transaction—whereas the decisions in *Schaeffer* and *Baird* recognize that, under the rationale of this Court's decision in *Raybestos-Manhattan Co.* v. *United States*, 296 U.S. 60, there are really two separable, although practically simultaneous, transfers—the conflict is not thereby obviated since the transactions involved in all three cases were plainly of the same kind. Moreover, the decisions in *Schaeffer* and *Baird* appear to accept the Government's position that, whichever analysis is adopted, the result for tax purposes should be the same under accepted principles of accrual accounting.

Nor does characterization of the instant taxpayer's right to the amounts in the dealer's reserve account as "so remote and contingent that it cannot be said to have become fixed and ascertained" (Appendix A, *infra*, p. 15) detract from the conflict with *Schaeffer* and *Baird*, since it is clear that in all three cases the taxpayers would eventually receive the amounts in the reserve accounts, either in cash or in the discharge of their respective obligations to the finance companies.

2. The necessary effect of the decision below is to permit a taxpayer, having a fixed right to income which is credited to him and which he will ultimately receive either in cash or by offset against his obligations, to avoid the reporting of the income in the year in which it is credited to him, despite the fact that he is on the accrual basis of accounting. This cannot be squared with the settled principle, stated by this Court in *Spring City Co.* v. *Commissioner*, 292 U.S. 182, 184-185, "that it is the *right* to receive and not the actual receipt

that determines the inclusion of the amount in gross income", and that "[w]hen the right to receive an amount becomes fixed, the right accrues". See, also, *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, 423; *Continental Tie & Lumber Co.* v. *United States*, 286 U.S. 290, 295.

It is of substantial importance to the revenue that this concept of accruability be preserved.[4] As the Court of Appeals for the Seventh Circuit has stated, if there is to be any "special consideration" for business enterprises allegedly "at the mercy of the finance companies", "it is for Congress to say so," not the courts. *Baird* v. *Commissioner*, decided June 20, 1958 (1 A.F.T.R. 2d 58-2014), Appendix C, *infra*, pp. 35-49. See, also *Schaeffer* v. *Commissioner* (C.A. 6th), decided August 20, 1958, Appendix C, *infra*, pp. 26-34. But cf. *Glover* v. *Commissioner*, 253 F. 2d 735 (C.A. 8th); *Johnson* v. *Commissioner*, 233 F. 2d 952 (C.A. 4th); *Texas Trailercoach, Inc.* v. *Commissioner*, 251 F. 2d 395 (C.A. 5th).

Resolution of the question presented is also important to the many taxpayers, in every part of the country, who are engaged in installment or conditional sales operations involving the same type of financing as in the instant case, and who, in the absence of a definitive ruling by this Court, will report income on different bases, depending on the jurisdiction in which the tax return is filed. Obviously, this inequality should be eliminated.

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[4] Putting aside the many related situations, the amounts involved in automobile dealer "reserve" cases are, themselves, very substantial, both currently and potentially.

CONCLUSION

There is a direct conflict among the circuits and the question involved is one of substantial importance in the administration of the revenue laws. This petition for a writ of certiorari should be granted.

Respectfully submitted,

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SEPTEMBER, 1958.

APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 15,821

JOHN R. HANSEN AND SHIRLEY G. HANSEN, PETITIONERS,

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

Aug. 4, 1958

Petition to Review a Decision of the Tax Court of the United States

Before: POPE, BARNES and HAMLEY, Circuit Judges

BARNES, Circuit Judge:

Taxpayers, husband and wife, have petitioned for review of a memorandum decision of the Tax Court sustaining deficiencies in income taxes for the years 1951, 1952, and 1953 and imposing penalties for failure to file estimated returns and for substantial underestimation of taxes for those years.

John R. Hansen (hereinafter referred to as petitioner) was, in the years in question, engaged in the business of selling new automobiles. It is stipulated that all such sales were financed by the General Motors Acceptance Corporation (GMAC). As a part of the normal course of dealing, and apparently pursuant to a GMAC "Retail Plan" referred to at the trial, GMAC paid Hansen 95% of the sales price of the car at the time of the sale and retained in a dealer reserve account the remaining 5%. GMAC also credited to that account a certain percentage of the financing charges as payments from the purchaser were received. Under

this arrangement no portion of the 5% reserve account was payable to Hansen except at the complete discretion of GMAC; and release of any funds was contingent on there being in the reserve account an amount in excess of 5% of all outstanding contracts. Petitioner, an accrual basis taxpayer, returned as income in the year of sale 95% of the sales price of each automobile sold. He did not accrue and return as income the GMAC reserves in the year of sale—the year they were established. His books reflected an asset account "Due Finance Co." and a liability account "Reserve for Repossession," but these were never taken into or deducted from income. Taxpayer used a specific charge-off account for bad debts arising from the business, but no losses on GMAC reserves were charged to this account. This bad debt account was unrelated to the credit sales financed through GMAC. Petitioner reported as income the amounts paid from these accounts in the year they were released to him by GMAC.

The Commissioner determined that the finance charge attaching to each sale was an integral part of the selling price; that the right to receive from the purchaser the full amount of the contract price was fixed in the year of sale; and that the dealer's reserve was contingent for possible losses and not a proper basis for reduction of gross income. The Tax Court sustained this determination, holding that the amount credited to the dealer's reserve was accruable into income in the year credited to the reserve account. The Tax Court also sustained the penalties for failure to file an estimated return and for substantial underestimation of taxes. From these two holdings, this petition for review was prosecuted.

I. Accruability of Dealer Reserves

The problem before us is not new to the tax law, although it is apparently one of first impression in this

Court. The Tax Court has consistently held dealer reserve accounts accruable in the year established, not in the year of actual payment to the dealer.[1] With equal consistency the Courts of Appeals and the District Courts have taken the opposite view.[2] The source of taxpayer's anguish in these cases is that a tax must be paid without the funds upon which the tax is levied being available for payment of the tax. This may often be the result of accrual accounting, just as it may be the result of operation of the doctrines of realization and constructive receipt. We are not impressed with the emphasis placed on this element of the case by those courts which have resolved the problem in favor of the taxpayer. On the other hand, the government is not being deprived of revenue in the long run. There is here no tax avoidance device. The dealer reserve amounts have always been reported as income in the year received. The only difference between the taxpayer and his government, therefore, is *when*, not whether, the amounts are taxable as income.

Certain principles are appropriate for review. A cash basis taxpayer records income upon actual or con-

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[1] *Evans Motor Co.*, 1957, 29 T.C. No. 62; *Kilborn*, 1957, 29 T.C. No. 14; *Morgan*, 1957, 29 T.C. No. 9; *West Pontiac*, 1957, 27 T.C. 749; *Texas Trailercoach*, 1956, 27 T.C. 575; *Brodsky*, 1956, 27 T.C. 216; *Blaine Johnson*, 1955, 25 T.C. 123; *Shoemaker-Nash*, 1940, 41 B.T.A. 417.

[2] *Glover* v. *Comm'r*, 8 Cir., 1958, 253 F.2d 735; *West Pontiac* v. *Comm'r*, 5 Cir., 1958, — F.2d —; *Texas Trailercoach* v. *Comm'r*, 5 Cir., 1958, 251 F.2d 395, reversing 27 T.C. 575; *Johnson* v. *Comm'r*, 4 Cir., 1956, 233 F.2d 952; *Modern Olds* v. *United States*, N.D. Tex., 1957, — F.Supp. —; *Hines Pontiac* v. *United States*, N.D. Tex., 1957, — F.Supp. —; *Massey Motors* v. *United States*, S.D. Fla., 1957, 156 F.Supp. 516; *Marine Chevrolet Co., Inc.* v. *United States*, 1958, — F.Supp. —; C.C.H. Fed. Tax. 1958, para. 9441. The issue is pending in this Circuit in *Morgan* v. *Comm'r*, #15898; in the sixth circuit in *Schaeffer* v. *Comm'r*, #13421; cf. *Keasby & Mattison* v. *United States*, 3 Cir., 1944, 141 F.2d 163. But cf. *Baird* v. *C.I.R.*, 7 Cir., decided June 20, 1958, — F.2d —.

structive receipt—and it is well to note that constructive receipt means that the taxpayer *has the present right to receive* funds which he, for his own reasons, chooses not to exercise (Treas. Reg. 118, § 39.42-2). An accrual basis taxpayer must record income, and pay tax thereon, upon *fixation* of the right to receive income, not upon its actual or constructive receipt.

> "When the right to receive an amount becomes fixed, the right accrues"[3]

With these basic concepts well in mind, we move to a consideration of the transactions here involved.

Hansen, as an automobile dealer, financed all sales exclusively through GMAC and all sales were written up on a form conditional sales contract supplied by GMAC. This contract provided for a "Total Time Price" computed, in a vastly simplified version, by adding to the cash price of the car (cost plus profit) the finance charges required by GMAC. This total time price reduced by the purchaser's down payment results in the "Time (Deferred) Balance" which becomes due and payable at the GMAC office in whatever number of installments are determined. This contract also provides, beneath the signatures of seller and purchaser, a "Dealer's Recommendation, Assignment and Guaranty," which provides, "for value received," for an immediate assignment to GMAC of the dealer's interest in the contract.

The transaction consummated and evidenced by this contract is subject to three possible interpretations. The government urges that there are here two separate sales: first, of the car by the dealer to the purchaser, giving rise to fixation of the right to receive the "Total Time Price" and requiring that amount to be accrued in the year of sale; second, of the conditional sales con-

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[3] *Spring City Co.* v. *Comm'r*, 1934, 292 U.S. 182, 184.

tract by the dealer to GMAC, for which GMAC pays less than the fair market value, but which can serve only as a basis for potential loss deductions not here pertinent.[4] We are in complete agreement with the Court in *Texas Trailercoach* v. *Comm'r*, 5 Cir., 1958, 251 F. 2d 395, that such a view is totally unrealistic. Such an artificial characterization of the transaction ignores entirely the complete integration of the financing institution that has become the hallmark of the automobile industry. It also ignores the uncontradicted evidence in the instant case showing that all sales were in fact so financed and that no sales could have been consummated without the financial assistance of GMAC.

The transaction, we believe, is properly construed as a single three-cornered arrangement involving the dealer, the purchaser, and the finance company.[5] But even so, this does not solve the problem. The transaction may still be seen as singular, while its elements are plural. It can be reasoned that the right to the sale price is fixed at the time of the contract, thereby requiring the dealer to accrue that amount, although he has actual receipt of only 95% thereof (*cf. Commissioner* v. *Cleveland Tr. Paving Co.*, 6 Cir., 1932, 62 F.2d 85.) The only amount not includable in the year of sale would then be that portion of the finance charges to which the dealer is entitled as they become fixed. (See the opinion of Black, J., in *Texas Trailercoach*, 1956, 27 T.C. 575, 580.) Although such an approach is entirely consistent with the principles of accrual accounting noted earlier, we are of the opinion that the peculiarities of automobile financing make this inter-

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[4] To infer, as does the government, that the only question here is one of deductions "seems to shut off the inquiry at the point where we would begin and raises a question . . . that is not present in the case before us." Texas Trailercoach v. Comm'r, supra, p. 397.

[5] Glover v. Comm'r, supra, note 2; Texas Trailercoach v. Comm'r, supra, note 2; Johnson v. Comm'r, supra, note 2.

pretation as unrealistic as that already rejected. We think Judge Wisdom ably and adequately stated the realities of this type of transaction in the *Texas Trailer-coach* case, *supra*, where at p. 397, after expressing the general belief that "Tax incidence should reflect the realities of a business transaction," he stated:

> "When we get down to what actually happens . . . we find one transaction, a three-cornered agreement with inter-related obligations of dealer, purchaser and finance company. Instead of being out of the first step of the transaction (the trailer sale to the purchaser), the finance company dictates the terms of the sale, has obligations running to it in the sales contract, has a fixed percentage for its finance charges worked into the sales price, and is as much a part of the substance of the business transaction as the dealer—whether or not it is the dealer who transfers the title formally to the purchaser, apparently for one hundred per cent of the purchase price. The hard core of the factual situation is that, under the three-way agreement, the dealer receives from the purchaser only a ninety-five per cent claim of right to the unpaid balance, plus a contingent claim, against the purchaser, to the remaining five per cent subject to a number of important conditions in favor of the finance company. The dealer transfers to the finance company, simultaneously, only what he receives from the purchaser. He receives from the finance company ninety-five per cent of the sales price plus a contingent claim, against the finance company, to the remaining five per cent then entirely under the dominion and control of the finance company. The dealer's claim to this five per cent may never become fixed or ascertainable; it may never be received."

At the time of the sale the only right which becomes fixed is the right to receive 95% of the sale price, and not the total time price, from the purchaser through GMAC. The amount credited to the dealer's reserve is completely controlled by GMAC. It is true an amount is fixed, but this amount is subject to unilateral depletion by GMAC to off-set repossession losses, prepayment refunds, and other charges determined by GMAC; the possibility of payment under this circumstance, although the maximum amount is determined, is so remote and contingent that it cannot be said to have become fixed and ascertained (*cf. Long Poultry Farms v. Comm'r,* 4 Cir., 1957, 249 F.2d 726, acquiesced in by the Commissioner, Rev. Rul. 57-358, 1958 P-H para. 54-503).

We have no quarrel with the theory of the Tax Court's position. Had the petitioner financed these sales himself, or elected to sell the contract as a separate transaction, the result reached below would be correct. The dealer's recourse in those situations necessarily would be limited to the reserve for loss deductions allowed under 26 U.S.C. § 166 (formerly 26 U.S.C. § 23 (k)(1)), or the installment sale provisions of 26 U.S.C. § 453(a) (formerly 26 U.S.C. § 44(a)). But that is not the factual case here presented. Petitioner had no such choices available to him. He was limited to a contract whereby he would finance through GMAC and receive only 95% of the sale price, or he had no contract at all. This being so, the portion actually paid to GMAC but earmarked for petitioner was not an amount to which his right of receipt became fixed. It became fixed only when GMAC decided it should pay out some of the funds held in the dealer's reserve.

Section 41 of the Internal Revenue Code of 1939 (now 26 U.S.C. § 446) requires net income to be determined in accordance with the taxpayer's method of accounting or by the Commissioner in accordance with

such methods as clearly reflect the income for the accounting period. A realistic view of the transactions of this petitioner confirms our conclusion that the Tax Court's re-allocation of income in accordance with the commissioner's assessment must be reversed in order to clearly reflect taxable income for the years in question.

II. Penalties

Petitioner admits that he filed no estimated returns during these years and the court below found that his failure was not due to reasonable cause. This finding is not disputed. The applicable provisions of the Internal Revenue Code of 1939 are § 294(d)(1)(A),[6] which provides a maximum 10% penalty for failure to file a declaration of estimated tax; and § 294(d)(2),[7]

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[6] "§ 294(d). Estimated tax

(1) Failure to file declaration or pay installment of estimated tax

(a) Failure to file declarations. In the case of a failure to make and file a declaration of estimated tax within the time prescribed, unless such failure is shown to the satisfaction of the Commissioner to be due to reasonable cause and not to willful neglect, there shall be added to the tax 5 per centum of each installment due but unpaid, and in addition, with respect to each such installment due but unpaid, 1 per centum of the unpaid amount thereof for each month (except the first) or fraction thereof during which such amount remains unpaid. In no event shall the aggregate addition to the tax under this subparagraph with respect to any installment due but unpaid, exceed 10 per centum of the unpaid portion of such installment. For the purposes of this subparagraph the amount and due date of each installment shall be the same as if a declaration had been filed within the time prescribed showing an estimated tax equal to the correct tax reduced by the credits under sections 32 and 35."

[7] "§ 294(d) (2) Substantial underestimate of estimated tax: If 80 per centum of the tax (determined without regard to the credits under sections 32 and 35), in the case of individuals other than farmers exercising an election under section 60(a), or 66⅔ per centum of such tax so determined in the case of such farmers, exceeds the estimated tax (increased by such

which provides a maximum 6% penalty for substantial underestimation of tax.[8]

Taxpayer argues that a logical interpretation of these sections precludes assessment of both penalties where there has been a failure to file the estimated return. His argument is that there can be no underestimate where there has been no estimate at all; and since every failure to file necessarily would be a substantial underestimation, the greater must include the lesser. This position has support in a number of cases following the decision in *United States* v. *Ridley*, N.D.Ga., 1954, 120

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credits), there shall be added to the tax an amount equal to such excess, or equal to 6 per centum of the amount by which such tax so determined exceeds the estimated tax so increased, whichever is the lesser. This paragraph shall not apply to the taxable year in which falls the death of the taxpayer, nor, under regulations prescribed by the Commissioner with the approval of the Secretary, shall it apply to the taxable year in which the taxpayer makes a timely payment of estimated tax within or before each quarter (excluding, in case the taxable year begins in 1943, any quarter beginning prior to July 1, 1943) of such year (or in the case of farmers exercising an election under section 60(a), within the last quarter) in an amount at least as great as though computed (under such regulations) on the basis of the taxpayer's status with respect to the personal exemption and credit for dependents on the date of the filing of the declaration for such taxable year (or in the case of any such farmer, or in case the fifteenth day of the third month of the taxable year occurs after July 1, on July 1 of the taxable year) but otherwise on the basis of the facts shown on his return for the preceding taxable year. 53 Stat. 88, as amended June 9, 1943, 7 p.m., E.W.T., c. 120, § 5(b), 57 Stat. 144; Feb. 25, 1944, 12:49 p.m., E.W.T., c. 63, Title I, § 118(a), 58 Stat. 37; May 29, 1944, 7 p.m., E.W.T., c. 210, Part I, §§ 6(b), (8), 13(b), 58 Stat. 235, 244."

[8] A third penalty, for failure to pay the estimated tax, was provided by § 294(d)(1)(B), but was specifically applicable only where a declaration had been filed. These three penalty provisions have now been consolidated into one 6% penalty for underpayment of estimated tax. Int. Rev. Code of 1954, § 6654.

F. Supp. 530.[9] The Courts of Appeals for the Fifth Circuit (*Patchen* v. *C.I.R.*, F.2d (July 23, 1958)), and the Third Circuit (*Abbott* v. *C.I.R.*, F.2d (July 31, 1958)), and the Tax Court, however, have taken the position that these provisions are independently applicable (see, e.g., *Fuller*, 1953, 20 T.C. 308, aff'd on other grounds, 10 Cir., 1954, 213 F.2d 102), and other District Courts have similarly decided: *Palmisano* v. *United States*, E.D. La., 1958, 159 F. Supp. 98; *Farrow* v. *United States*, S. D. Cal., 1957, 150 F. Supp. 581; *Erwin* v. *Granquist*, D. Ore., 1957, aff'd on other grounds, 9 Cir., 1958, 253 F.2d 26, cert. denied, May 19, 1958.[10]

Were we compelled to base our decision on logic alone, we are by no means convinced that it is not as logical to read the two code sections as imposing cumulative penalties as one. However, Congress has on two occasions expressed its intention that both these penalty provisions are applicable to a taxpayer who has failed to file a declaration of estimated tax. The Senate and conference reports on the original bill containing these provisions (57 Stat. 126) contain the following language:

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[9] Accord, *Acker* v. *C.I.R.*, 6 Cir., 1958, —— F.2d ——; *Barnwell* v. *United States*, E.D.S.C., 1958, —— F.Supp. ——; *Jones* v. *Wood*, D. Ariz., 1957, 151 F.Supp. 678; *Stenzel* v. *United States*, N.D. Cal., 1957, 150 F.Supp. 634; *Powell* v. *Granquist*, D. Ore., 1956, 146 F. Supp. 308, aff'd on other grounds, 9 Cir., 1958, 252 F.2d 56; *Owen* v. *United States*, D. Neb., 1955, 134 F. Supp. 31; *Witt* v. *Tomlinson*, S.D. Fla., 1958 —— F.Supp. ——, P-H Current Decisions 58-1350; *Glass* v. *Dunn*, P-H Fed. Tax, 1956, para. 73,100.

[10] Accord, *Abbott*, 1957, 28 T.C. 798, aff'd, 3 Cir., 1958, —— F.2d ——; *Beacham*, 1957, 28 T.C. 598, aff'd, *Beacham* v. *C.I.R.*, 5 Cir., 1958, 255 F.2d 103; *Kaltreider*, 1957, 28 T.C. 121; *Patchen*, 1956, 27 T.C. 592, aff'd, *Patchen* v. *C.I.R.*, 5 Cir., —— F.2d —— (July 23, 1958); *Acker*, 1956, 26 T.C. 107, rev'd, *Acker* v. *C.I.R.*, 6 Cir., —— F.2d —— (June 18, 1958). *Cf. Prokop* v. *C.I.R.*, 7 Cir., 1958, 254 F.2d 544.

> "In the event of a failure to file a declaration where one is due, the amount of the estimated tax for the purposes of this provision (§ 294(d)(2)) *will be zero.*"[11]

Thus it is abundantly clear that Congress was aware of the difficulty in measuring the underestimation penalty where no estimate was filed and pursuant to this understanding indicated that in the event of a failure to file, the amount of the estimated tax would be presumed to be zero. No other conclusion is possible but that Congress intended § 294(d)(2) penalties even in a situation giving rise to § 294(d)(1)(A) penalties, that is, a failure to file is also a substantial underestimation of taxes due. Subsequent amendments to these provisions changed the amounts of the penalties, but in no way altered their substantive effect.

In the 1954 revision of the Internal Revenue Code, Congress recognized the double-barreled operation of these statutes in stating:

> "This charge (for underestimation) and the charge for failure to file a declaration or pay an installment of estimated tax may run concurrently and result in a combined charge of 15 (sic) percent of the estimated tax due."[12]

And the more lenient provisions of the present 26 U.S.C. § 6654 resulted. Thus at the time Congress changed the law, it recognized what the law then was.

We conclude from these expressions of congressional intent that where a taxpayer fails to file a declaration of estimated tax he was formerly, and during the years here involved, liable for the penalties imposed by § 294

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[11] S. Rep. No. 22, 1943 Cum. Bull. 1314, 1345; Conf. Rep. No. 510, 1943 Cum. Bull. 1351, 1372. (Emphasis added.)

[12] H. Rep. No. 1337, 3 U.S.C. Cong. & Adm. News 4017, 4127 (1954).

(d)(2) as well as for those imposed by § 294(d)(1)(A). In this respect the decision of the Tax Court is affirmed.

The judgment is affirmed as to the penalties assessed, but as to the imposition of tax on the dealer reserves the judgment is reversed and remanded for recomputation and entry of judgment in accordance with this opinion.

(Endorsed:) Opinion. Filed Aug. 4, 1958.

PAUL P. O'BRIEN,
Clerk.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 15821

JOHN R. HANSEN, ET AL., APPELLANT,

vs.

COMMISSIONER OF INTERNAL REVENUE, APPELLEE

Upon Petition to Review a Decision of The Tax Court of the United States.

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States, and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the decision of the said Tax Court of the United States in this Cause be, and hereby is affirmed as to the penalties assessed, but as to the imposition of tax on the dealer reserves the decision is reversed, and that this cause be, and hereby is remanded to the said Tax Court for recomputation and entry of judgment in accordance with the opinion of this Court.

APPENDIX B

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42 [as amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * * * *

(26 U.S. C. 1952 ed., Sec. 42.)

Rev. Rul. 57-2, 1957-1 Int. Rev. Bull. 17:

> Amounts withheld by banks or finance companies to cover possible losses on notes purchased from dealers constitute income to dealers employing the accrual method of accounting, to the extent of their interest therein at the time the amounts are recorded on the books of the bank or finance company as a liability to the dealer, regardless of whether charges for worthless notes are also made to the account pursuant to an agreement between the parties. Losses sustained on worthless notes shall be separately established by the dealer as required by section 166 of the Internal Revenue Code of 1954.

The Internal Revenue Service has been requested to state its position with respect to the treatment, for Federal income tax purposes, of amounts withheld by banks and finance companies to cover possible losses on notes purchased from automobile or other dealers employing the accrual method of accounting, and which are recorded on the books of the bank or

finance company as a liability of the bank or finance company to the dealer.

The steps generally involved in transactions concerning automobile dealers are as follows: When a car is purchased on credit from a dealer, the purchaser makes a down-payment, either in the form of cash or by turning in another car at an agreed value, the balance being satisfied by the purchaser's promissory note and a supporting conditional sales contract. The face amount of the note reflects two elements—the balance of what would be the purchase price of the car, if bought for cash, and a finance charge. As between the purchaser and the dealer, the transaction is closed and completed at this point with the attendant tax consequences to the dealer.

It is then common practice for the dealer to sell or discount the purchaser's note and sales contract to some financial institution. The finance company or bank acquires the note at a value somewhat less than its face value, the difference representing a charge for its service. Simultaneously, either cash or unrestricted credit is given to the dealer to the extent of the amount reflected in the face value of the note that corresponds to the unpaid balance of the cash retail price of the car. The difference between the face value of the note and the sum of the finance company's charge and its credit or immediate payment to the dealer (representing part of the finance charge previously mentioned) is then credited on the books of the finance company as a liability of the finance company to the dealer. The accumulation of these credits is generally known as a "dealers reserve" and is the specific object of the present consideration.

Settlement of the liability represented by the reserve is subject to agreement between the particular

dealer and the financial institution involved. In some instances, the agreement does not contemplate the charging of any items against the reserve account, while in others the account reflects a running record of various transactions between the parties, that is, both credits and charges are entered, depending upon the nature of the item. Thus, in certain instances, the dealer and the finance company may agree that notes purchased or discounted are to be charged to the reserve account in the event they become worthless.

With regard to those instances where losses incurred by a finance company on notes purchased from automobile dealers may not be charged against the reserve, the credits to the reserve, by the finance company in favor of a dealer who employs the accrual method of accounting constitute income to the dealer at the time such credit is made, even though the dealer is not immediately or even currently able to draw on the entire reserve. See G. C. M. 9571, C. B. X.-2, 153 (1931), and *Shoemaker-Nash, Inc.* v. *Commissioner,* 41 B.T.A. 417. The principles involved in the purchase of notes from automobile dealers by banks or finance companies as described above are equally applicable where notes are purchased, under similar conditions, from dealers in items other than automobiles.

Where a dealer's reserve is in the nature of a running account, the charging thereto of worthless notes pursuant to agreement between the parties has no bearing upon the fact that taxable income has been received by the dealer, or upon the time of its realization as otherwise evidenced by the credits to such reserve.

Accordingly, it is held that credits to such reserve, in the case of a dealer employing the accrual method

of accounting, constitute income to the dealer at the time such credits are made regardless of whether charges to the account for worthless notes are also made pursuant to an agreement between the parties. Losses sustained on worthless notes are to be separately established by the dealer as required by the provisions of section 166 of the Internal Revenue Code of 1954 relating to bad debts.

In arriving at these conclusions, consideration has been given the case of *Blaine Johnson et al.* v. *United States*, 233 Fed. (2d) 952. See also, *Albert M. Brodsky et ux.* v. *Commissioner*, 27 T.C. No. 23.

APPENDIX C

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

No. 13,421

J. H. SCHAEFFER, JR., AND OPAL R. SCHAEFFER, PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

On Petition for Review of the Decision of the Tax Court of the United States.

Decided August 20, 1958.

Before: SIMONS, Chief Judge, MILLER, Circuit Judge, and CECIL, District Judge.

MILLER, Circuit Judge. The petitioners filed this action in the United States Tax Court seeking a redetermination of deficiency income tax assessments for the years 1952 and 1953, resulting from the failure on the part of the petitioners to include in gross income certain credits in their favor on the books of a finance company, which the Commissioner ruled constituted accrued taxable income. The Tax Court upheld the assessments, which ruling is now before us on petition for review.

The facts, which were for the most part stipulated, were found by the Tax Court as follows. Petitioners, who are husband and wife, are residents of Germantown, Tennessee. They filed joint Federal income tax returns for the years 1952 and 1953. J. H. Schaeffer, Jr., the husband, hereinafter referred to as "petitioner" operated a retail used automobile business as an individual proprietor during 1952 and 1953 under

the trade name of J & S Motors. The books and accounts of the business were kept on an accrual basis. In the normal course of the operation of the business petitioner sold notes executed by purchasers of automobiles under conditional sale contracts to banks and finance companies. Certain notes executed by such purchasers were sold in 1952 and 1953 by petitioner without recourse on petitioner to Memphis Bank & Trust Company and Guardian Discount Company, both of Memphis, Tennessee. These were closely related corporations in organization, operation and business practices, having the same principal place of business, and for the purposes of this opinion will be referred to collectively as the "Finance Company."

During 1952 and 1953 whenever notes, executed by purchasers of automobiles from J & S Motors and secured by conditional sales contracts on such automobiles, were purchased from J & S Motors by the Finance Company certain payments were made to J & S Motors and certain reserves were withheld and credited to two separate and distinct reserve accounts on the books of the Finance Company. These reserves were identified on such books as "Loss Reserve" accounts and "Special Reserve" or "Rebate" accounts. Whether the amounts credited by the Finance Company to the Loss Reserve accounts constituted taxable income for the years 1952 and 1953 is the question presented. Contrary to their original contention, petitioners now concede that the amounts credited to the Special Reserve or Rebate accounts constituted taxable income, and no issue is presented on the present review with respect thereto.

Under the agreement between petitioner and the Finance Company, the amounts withheld and credited to the Loss Reserve accounts were usually 2 per cent of the notes. However, the percentage withheld varied

in amount with the model of the car, and a larger percentage was withheld on older models. The creation and operation of the Loss Reserve accounts is shown by the following typical transaction. J & S Motors, in selling an automobile to a customer, would first obtain from the customer a credit statement which it submitted to the Finance Company. If the purchaser's credit was satisfactory J & S Motors made out a bill of sale indicating who held the lien on the automobile and informing the purchaser where payments were to be made. The purchaser would sign a conditional sale contract and make a down payment, consisting of a trade-in or cash or both. The following is an example of such a sale made July 26, 1952.

Cash Price	$833.00
Net trade-in allowance	228.00
Cash on delivery	60.00
Total down payment	288.00
To finance	545.00
Sales tax	6.90*
Insurance costs	100.07
Finance charges	195.53
Total time balance	840.60

Upon completion of a sale J & S Motors would take the conditional sale contract to the Finance Company and receive from it a check for the balance of the purchase price. In the sale of July 26, 1952, referred to above, the Finance Company reflected the purchase of the conditional sale contract as follows.

Notes Receivable	$840.60
Cash, payment to J & S Motors	545.00
Cash, payment of insurance premium	100.07
Loss reserve, J & S Motors	24.23

* This item was apparently not included in computing the total.

Special rebate, J & S Motors	113.33
Income	57.97
Total	$840.60

The books of J & S Motors did not reflect the reserves as income. The only amount recorded as income from the sale of an automobile was the price of the car, as if cash had been paid. By agreement between petitioner and the Finance Company, the Loss Reserve accounts of petitioner were chargeable with any and all losses and costs incurred by the Finance Company in connection with or related to notes purchased from the petitioner. In addition, there was a verbal agreement between petitioner and the Finance Company that J & S Motors would further guarantee the company against loss by repurchasing repossessed cars from it at a fair retail price.

No amounts were payable to petitioner out of such Loss Reserve accounts until the balance of such accounts exceeded 4 per cent of the total value of outstanding and unpaid balances on all notes purchased from petitioner. No payment was to be made out of such accounts as long as any debt owed by petitioner to the Finance Company was due and unpaid. During all of 1952 and 1953 amounts credited to the Loss Reserve accounts on the books of the Finance Company were held as security against losses on notes purchased from J & S Motors. The balances on Loss Reserve accounts did not at any time during 1952 or 1953 exceed 4 per cent of the outstanding value of or amount payable on notes purchased from J & S Motors by the Finance Company. During 1952 and 1953 the petitioner did not receive any of the Loss Reserves credited on the books of the Finance Company. However, if all of the purchasers of automobiles whose notes were held by the Finance Company had met their payments on

time, J & S Motors was entitled to receive the entire balances in the accumulated Loss Reserve accounts.

None of the amounts added to the Loss Reserve accounts were treated or reported as income by the petitioners. The deficiency assessments herein involved resulted from the Commissioner's ruling that petitioner's net income for the years in question should be increased by the amount of the net increases during 1952 and 1953 in the Loss Reserve accounts. Such net increases were $4,064.29 and $8,481.95, respectively, with the net balance increasing from $2,268.74 on December 31, 1951, to $14,814.98 on December 31, 1953. The Commissioner did not include in taxable income all of the amounts added to the Loss Reserve accounts in a particular year, but included only the net increases in such accounts, after allowing for actual losses arising out of defaults occurring in each of the taxable years.

Since petitioner was on an accural basis for income tax purposes, the amounts in question constituted taxable income if they accrued to the petitioner during the taxable year, even though he did not actually receive them during the year. "Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the right to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues." *Spring City Foundry Co.* v. *Commissioner*, 292 U.S. 182, 184-185; *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, 423. The application of this well settled rule to cases involving factual situations similar to the present one has been the subject of considerable litigation. The petitioners' contention that the credits did not accrue as income in 1952 and 1953 finds support in *Johnson* v. *Commissioner*, 233 F. (2)

952, C.A. 4th; *Texas Trailercoach, Inc.*, v. *Commissioner*, 251 F. (2) 395, C.A. 5th; and *Glover* v. *Commissioner*, . . . F. (2) . . . , C.A. 8th, decided April 23, 1958. See also: *Commissioner* v. *Cleveland Trinidad Paving Co*, 62 F. (2) 85, C.A. 6th; *Keasbey & Mattison Co.* v. *United States*, 141 F. (2) 163, C.A. 3rd. The Commissioner's contention is supported by numerous tax court decisions, including *Shoemaker-Nash, Inc.*, v. *Commissioner*, 41 B.T.A. 417; *Brodsky* v. *Commissioner*, 27 T. C. 216; and *Kilborn* v. *Commissioner*, 29 T.C. No. 14, decided October 24, 1957, and by *Baird* v. *Commissioner*, . . . F. (2) . . . , C.A. 7th, decided June 20, 1958. Three of the cases relied upon by petitioners, *Johnson* v. *Commissioner*, supra, *Texas Trailercoach, Inc.*, v. *Commissioner*, supra, and *Glover* v. *Commissioner*, supra, are reversals of Tax Court decisions which also upheld the Commissioner's contention. The opinions in the cases above referred to contain a review of the authorities and a thorough discussion of the question, which it is unnecessary to repeat in this opinion. Basically, the cases sustaining the petitioners take the position that the amounts credited to the Reserve Loss accounts were payable to the petitioner only upon various conditions precedent, which were contingencies which might bar indefinitely the dealer's receipt of the payments or the right to receive any payments at all from the account, thus constituting them contingent credits, rather than accrued income. The cases supporting the Commissioner's contention express the view that the amounts credited by the Finance Company to the Reserve Loss accounts were carried by the Finance Company and recognized by it as a liability in favor of the petitioner, that petitioner's legal right to them was undisputed, and that only the time of payment was deferred. *Franklin County Distilling Co., Inc.*, v. *Commissioner*, 125 F. (2) 800, C.A.

6th. The fact that the exact amount to be paid is not determined until a later year is not material. *Continental Tie & Lumber Co.* v. *United States,* 286 U.S. 290, 295.

We agree with the Commissioner that there was nothing contingent about petitioner's legal right to the amounts so credited. The only contingency which existed was how much of these amounts would not be paid to the petitioner but would be applied by the Finance Company to the payment of petitioner's legal obligations. The contingency was in the amount of the offset, not in the amount of the accrued income. *Brown* v. *Helvering,* 291 U.S. 193, 200-201. For income tax purposes, the amount of accrued income was fixed and did not vary. Although the amount of the credit on the books of the Finance Company might be later reduced, such reduction would be the result of the Finance Company using a portion of the credit to discharge petitioner's legal obligations, which automatically offset any reduction in the credit. The payment of a legal obligation of a taxpayer is income to the taxpayer even though such income is not actually received by him. *Old Colony Trust Co.* v. *Commissioner,* 279 U.S. 716, 729; *Tressler* v. *Commissioner,* 228 F. (2) 356, 359, Note 6, C.A. 9th; *Northern Trust Co. of Chicago* v. *United States,* 193 F. (2) 127, C.A. 7th. The immediate payment of the amounts so credited was prevented only because petitioner pledged these amounts to secure other possible obligations of his own that might later arise.

The liabilities, the payment of which was secured by the Loss Reserve accounts, were contingent liabilities of the petitioner, such as *might* result from probable default on the part of the obligors in making the required payments. *Bernstein* v. *United States,* 234 F. (2) 475, 481, C.A. 5th. The tax on income received in

one year can not be withheld because losses may thereafter occur in a later year or because the ultimate result of a particular transaction may be a loss instead of a profit. *Heiner* v. *Mellon*, 304 U.S. 271, 276; *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 364. Such obligations can be taken as income tax deductions only in the year in which they become actual liabilities. *Brown* v. *Helvering*, supra, 291 U.S. 193, 200-201; *E. H. Sheldon & Co.* v. *Commissioner*, 214 F. (2) 655, 656, C.A. 6th; *Franklin County Distilling Co., Inc.*, v. *Commissioner*, supra, 125 F. (2) 800, 804, C.A. 6th. When a taxpayer is on the accrual basis losses are handled separately from income even though they relate to an item of gross income which has accrued in the same year. *Spring City Foundry Co.* v. *Commissioner*, supra, 292 U.S. 182, 185. Under the ruling in *Brown* v. *Helvering*, supra, 291 U.S. 193, and *Heiner* v. *Mellon*, supra, 304 U.S. 271, 276, the Commissioner's position must be sustained.

The foregoing analysis of the question considers the transaction only as one between the petitioner and the Finance Company. Before that transaction was entered into, the petitioner concluded a prior transaction with the purchaser of the automobile which, we believe, is the controlling factor in the case. Petitioner in selling a car to a purchaser and in taking the purchaser's note and conditional sale contract acquired an asset in the nature of an account receivable, with respect to which there was no contingency whatsoever. As between petitioner and the purchaser of the automobile, the entire amount of the contract obligation accrued to the petitioner. If such account receivable became uncollectible in whole or in part, the question was one of taking a deduction under the applicable statute. *Spring City Foundry Co.* v. *Commissioner*, supra, 292 U.S. 182, 185. There was no obligation on the part of the peti-

tioner to sell this account receivable to the Finance Company. Actually, in a number of instances the petitioner did not sell such an account receivable and the amount called for by his contract was treated by him as taxable income. We see no reason why the completed transaction with the purchaser should not be treated in the same way in other instances where the petitioner without any legal obligation on his part to do so sells the account receivable to a finance company. The income has accrued to the petitioner before the transfer is made to the Finance Company, and such subsequent transfer does not change the legal effect of the prior completed transaction. *Baird* v. *Commissioner*, supra, . . . F. (2) . . . , C.A. 7th. See: *Chamberlin* v. *Commissioner*, 207 F. (2) 462, 469, C.A. 6th, cert. denied, 347 U.S. 918.

The decision of the Tax Court is affirmed.

IN THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

No. 12230

SEPTEMBER TERM, 1957 APRIL SESSION, 1958.

CLIFTON E. BAIRD and VIOLET L. BAIRD, PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

Petition for Review of Decisions of the Tax Court of the United States.

June 20, 1958

Before SCHNACKENBERG and PARKINSON, *Circuit* Judges, and PLATT, *District Judge*.

SCHNACKENBERG, *Circuit Judge*. Clifton E. Baird and Violet L. Baird, husband and wife, filed a petition for review of decisions of the Tax Court of the United States in a proceeding initiated by petitions filed by them in that court. Evidence consisting of exhibits and testimony was received by the Tax Court, which entered findings of fact and filed an opinion.[1] The decisions now under attack determined income tax deficiencies for the years 1952, 1953 and 1954, in the amounts of $16,499.72, $23,086.16, and $7,434.72, respectively.

The facts are stipulated by the parties[2] and as found by the Tax Court may be summarized as follows:

Taxpayers are husband and wife residing in Salem, Indiana. They filed joint returns on a cash basis for the calendar years involved with the district director of In-

[1] Tax Court Memo. No. 192 (1957).

[2] The stipulation included, *inter alia*, certain testimony in a prior case of *Blaine and Evelyn K. Johnson*, No. 52306, in the Tax Court.

ernal Revenue for the District of Indiana. They are equal partners, doing business under the name Baird Trailer Sales. The partnership has engaged since its organization in January, 1947, in the sale of new and used mobile homes, or house trailers, and to a lesser extent in new and used cars, parts and accessories, furniture, and real estate, in Salem, Indiana.

Partnership returns were filed for the fiscal years ended February 28, 1952, 1953, and 1954,[3] and an amended return for the fiscal year ended February 28, 1952. The partnership kept its books and filed its income tax returns on an *accrual method* of accounting. The partnership books reflect the following gross sales and costs of sales for the relevant years:

	1952	1953	1954
Gross sales	$1,025,943.89	$1,337,385.64	$1,067,144.18
Cost of sales	859,746.75	1,141,308.59	908,027.87

During that period, the partnership sold to either of two finance companies or a bank[4] unpaid notes, chattel mortgages and conditional sales contracts.[5] The proceeds of such sales were paid by the finance companies to the partnership, with this exception: a part was withheld by each finance company and credited to the dealer's reserve account of the partnership on the finance company's books.[6] The partnership either endorsed with recourse retail paper sold to the finance companies or guaranteed its payment. It was agreed between the partnership and the finance companies:

> (a) In the event the retail paper became due and unpaid, the finance company could charge the dealer's reserve with the unpaid balance;

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[3] Herein sometimes referred to as the "relevant years".

[4] All sometimes referred to herein as "finance companies".

[5] Herein sometimes referred to as "retail paper".

[6] The part withheld by the bank was deposited in an account designated "dealer eserow account" in the name of the partnership.

(b) In the event the partnership had a matured financial obligation of any nature to the finance companies,[6a] the amount of such obligation could be charged to the dealer's reserve account;

(c) Repossession losses of the finance companies[6a] could be charged to the dealer's reserve account;

(d) The ultimate balance in the dealer's reserve account after payment of all notes by the partnership to the finance companies[6a] was to be paid to the partnership; and

(e) Each finance company could look to the balance in the dealer's reserve account to satisfy any default by the partnership on its guaranties and obligations to the finance company, as well as any default by the makers of the notes.

The partnership was not required by any finance company to do business with it to the exclusion of any other company.

The partnership was not financially able to carry the contracts of sale or the floor plan and carry the inventory of trailers held for sale, but relied upon the finance companies. For its own convenience, it procured and used in its sales legal forms furnished by the finance companies.

The account on each finance company's books designated "dealer's reserve" for the partnership was reflected as a liability of the finance company and the annual balances in such account were not reflected in its income.

During the relevant years, the partnership (by way of illustration) recorded the sale of a trailer and the sale of the retail paper on its books and records as follows:

[6a] The word "companies" appears in the stipulation from which the quoted paragraphs are taken.

Sales Receipt Journal Entry		
Cash and/or Trade-in Allowance	$1,745.00	
Contracts Receivable-Finance Company	3,800.00	
Trailer Sales		$5,545.00

When the finance company remitted to the partnership, the following entry was made:

Reserve-Finance Company	$ 190.00	
Cash	3,632.67	
Expense for Intangible Stamps	1.38	
Contracts Receivable		$3,800.00
Expenses (Credit Check)		24.05
Cost of Sales		$3,824.05
Cost of Sales	$3,824.05	
Credit Inventory		$3,824.05

When a purchaser defaulted on his contract and note, the trailer was repossessed upon receipt of notice of default. The partnership always paid the finance company the unpaid balance due on such note and recorded such payment on its books and tax returns as a purchase. Where defaults occurred on the notes payable to the partnership, the payments made to the finance companies as a result of the defaults were included on the partnership's returns for the relevant years as a part of cost of goods sold. On resale of the repossessed trailer, the receipts therefrom were reported as gross receipts.[7]

[7] For example, if a trailer costing $5,545 with notes payable outstanding of $3,500 was repossessed and the trailer's fair market value was only $3,000, the loss, if any, was reflected on the partnership's books and records as part of cost of goods as follows: The bookkeeper of the partnership either on the date of repossession or at the close of the fiscal year charged $500 to overallowance on trailers and recorded the purchase price of the trailer in cost of used trailers at $3,000 (its fair market value). However, if the trailer was sold during the fiscal year in which it was repossessed, and the bookkeeper had not charged $500 to overallowance on trailers, the purchase price of the trailer was reflected in cost of used trailers at $3,500, and the sales price of $3,000 reported in gross receipts. In the event the notes payable outstanding were $3,000 or less in the above example, the purchase price of the trailer was reflected in cost of used trailers at the amount paid by

The following table shows the amounts credited on the books of said finance companies in the dealer reserve accounts of the partnership and the amounts it received from those and other finance companies in the years indicated:

Fiscal year ended February 28	Credited by said finance companies in dealer reserve accounts of partnership	Received by partnership from all finance companies
1952	$25,816.58	$1,217.94
1953	29,560.54	1,778.94
1954	29,660.49	9,141.39

On its returns for the relevant years, the partnership deducted specific bad debts in the respective amounts of $1,203.75, $2,239.12, and $1,203.69. Such deductions included unpaid amounts due the partnership for accessories, supplies and repairs. But what is significant here is that such deductions also included advances by the partnership to meet trailer purchaser's payments which the purchaser was unable to make and after advancement a default by the purchaser occurred.

In computing the gross receipts reported in its returns for the relevant years, the partnership deducted from gross sales the total amount credited by the finance companies in each year to the partnership's account designated "dealer's reserve". However, the Commissioner included such amounts in the partnership's income. In determining the contested deficiencies, the Commissioner reduced the total amounts credited by the finance companies to the partnership dealer's reserve accounts by the amounts received by the partnership from the finance companies in the relevant years,

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the partnership on the unpaid balance of the note payable. The finance company remitted to the partnership the amount which had been credited to the account designated "dealer's reserve" with respect to such defaulted contract and note and the partnership reported such amount in taxable income for the year of receipt, except for the years 1948 and 1949, when the credit to the amounts designated "dealer's reserve" were included in taxable income.

and added the net amounts to the partnership income.

No delinquent notes were charged to the partnership's dealer's reserve accounts by any finance company during the relevant years. During these years the finance companies were in such good financial condition that they were able to pay any accounts which might have been due and payable to the partnership out of the dealer's reserves.

The Tax Court held that the amounts of the dealer's reserves withheld by the finance companies during the relevant years and credited to the partnership's account on the finance companies' books were includible in taxpayers' taxable income in the years withheld and credited.

Taxpayers argue that the amounts withheld by finance companies and credited to dealer's reserve accounts on their books are not accruable in the year of withholding because extreme contingencies rendered most uncertain the right of taxpayers to such amounts; that the agreements between the partnership and each of the finance companies severely restricted the right of the petitioners to the amounts withheld; that the hold-back and other restrictive provisions of these agreements were dictated by the finance companies to protect themselves against losses; that the partnership was forced to acquiesce in these unfavorable terms in order to do business with the finance companies; and that the credits in the dealer's reserve accounts were not partnership assets. Finally they argue that the trailer contracts and notes were sold by the partnership solely because of its immediate needs for cash funds, since the business would have been much more profitable if the partnership had been financially able to retain such paper.

The Commissioner argues, in part, that the Tax Court correctly held that amounts withheld by finance companies, in purchasing trailer and automobile notes and

contracts from the partnership, and credited to reserve accounts in its name on the finance companies' books were includible in the taxpayers' gross income for income tax purposes in the years withheld and credited. Since the partnership was on the accrual basis, the entire profit to it from the sale of trailers and automobiles was properly includible in taxpayers' gross income at the time of sale, even though some deferred payments would not be received until a subsequent period and even though there was a possibility that the purchasers would default. He concluded that the partnership's practice of accruing less than the entire sales price is inconsistent with the accrual method of accounting.

At the outset we consider what amounts to a plea for sympathy and equitable relief made by taxpayers:

> "It is obvious that the high risk element in the sale of house trailers severely limited the market for trailer coach paper and gave heavy bargaining leverage to financing institutions. As a result, the finance companies have come to exercise considerable control over a dealer's business practices and frequently participate in and police a dealer's sales.
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> "The general uncertainty of the partnership in its relationship with the finance companies is also illustrated by the fact that the sale of contracts and notes took place only because the partnership was in pressing need of funds. * * *
>
> "It is obvious that the partnership would have been much more profitable if it had been able to retain the notes and contracts received from the purchasers of its trailers. If it had been able to go forward in this fashion, it could have then realized not only the profit on the sale of the trailer, but the

not inconsiderable amounts which flowed from the finance charges and other 'extras.' If the partnership had been able to hold its own paper and had not been required to discount it with the finance companies, it could have reaped the financial harvest which the finance companies were able to obtain.

* * * * *

"The basic agreements disclose that the partnership was at the mercy of the finance companies in the arrangements which are involved in the instant cases. The contingencies on payments to the partnership were created by the finance companies for their protection, not by the partnership."

While we admire the courage of those who, without sufficient capital, enter into a competitive business field, where (it is asserted) risks are high and many,[8] we are aware that such an entry is voluntary and we know of no power which courts have to grant relief from the burden of income tax laws to persons who thus find themselves "at the mercy of the finance companies." Congress has power to lay and collect income taxes.[9] If the application of the income tax law to persons situated as taxpayers say they were, requires special consideration, it is for Congress to say so, not us. Our duty is to ascertain what the law is and apply it to this case.

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[8] This assertion by taxpayers is refuted by the record, which shows that for the relevant years no delinquencies were charged to the dealer's reserve accounts by any finance company, and further that during said years the total deductions by the partnership for bad debts, *only a part of which were advances by the partnership to meet defaults in payment by purchasers*, amounted to only $1,203.75, $2,239.12 and $1,203.69. As hereinbefore shown, the gross sales for the same years were each well over one million dollars.

[9] Amendment XVI of the Constitution of the United States.

We may well start with *Spring City Co.* v. *Commissioner*, 292 U.S. 182, which affirmed this court, 67 F.2d 385. At 184, the Chief Justice said:

> "* * * Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues. When a merchandising concern makes sales, its inventory is reduced and a claim for the purchase price arises. * * *"

In a layman's language, an accrual method means that you report income when earned, even if not received, and deduct expenses when incurred, even if not paid, within the taxable period.

In the case at bar, the partnership, in a typical case, completed the transaction of the sale of a trailer at the time the down payment was made, either in cash or trade-in allowance, or both, and the purchaser executed and delivered to it notes and a chattel mortgage or conditional sales contract. The partnership thus acquired a complete enforcible right to receive the remainder of the purchase price at the times specified in the retail paper. The circumstance that the partnership was or was not financially able to retain the paper and collect it as it became due does not preclude the fact that its entire profit on the transaction *accrued* at that time regardless of when received. Therefore, no portion of the profit is rendered nontaxable at that time by the subsequent act of the partnership in selling the retail paper to a finance company in a transaction which left a part of the sales price of the paper temporarily retained as security by the finance company. It is significant and consistent with the law that the finance companies did not take into income the amounts cred-

ited on their books to the partnership in the dealer's reserve accounts.

Ultimately only two things could happen to the funds in the dealer's reserve accounts: either the amounts would be paid to the partnership in cash or they would be used to satisfy the partnership's other obligagations to the finance companies. There is no showing that the amounts in the reserve would not be collectible from the finance companies at the appropriate time or that their collection would be improbable, for the companies were in sound financial condition and at all times able to pay out the amounts withheld in the reserves. The only thing which would prevent the partnership from receiving the full sales price would be a purchaser's default, which is not a contingency sufficient to defer the accruing of income that has already been earned. If the partnership eventually sustains such a loss, it is recognized that it would be entitled to a business deduction therefor, because it would be a debt, or portion thereof, arising from sales that had been included in income, and which was thereafter ascertained to be worthless. Actually the partnership elected, on its returns for the relevant years, to use the bad debt deduction method, when it deducted for those years the amounts hereinbefore referred to. Significantly these amounts consisted, in part, of advances made by the partnership to the finance companies to meet trailer purchaser's payments which the purchaser was unable to make and, after advancement, the purchaser defaulted.

Taxpayers do not seek to take advantage of 26 U.S.C.A. 23 (k) (1) of the 1939 Internal Revenue Code, insofar as a deduction, in the computation of net income, is allowed ("in the discretion of the Commissioner") for a reasonable addition to a reserve for bad debts. This position taxpayers are forced to take because of their contention that the withheld part of the

sale price did not accrue to them during the relevant years. However, quite inconsistently with their argument that the withheld amounts were not accrued income to the partnership, the latter did claim, as deductions, debts included in said accounts which defaulted within the relevant years. As the court said in *Rogan v. Commercial Discount Co.*, 149 F.2d 585,[10] at 586:

> "At all times pertinent to this inquiry, the taxpayer was operating under the reserve method for handling bad debts and did not employ the charge-off method. The statute allows these alternative methods, but having made an election as to which method it would adopt, it could not change to the other method in the absence of the Commissioner's express permission. * * *"

It is, therefore, apparent that, although § 23(k)(1) permits the deduction of *either*, first, specific debts which become worthless within the taxable year or, secondly, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts, the partnership chose to use the specific debt charge-off method for bad debts, and should not be allowed any deductions as a reserve for bad debts.

In *Universal Oil Products Co.* v. *Campbell*, 181 F.2d 451, (cert. denied, 340 U.S. 850, rehearing denied, 340 U.S. 894) at 470, we said:

> "Vague possibilities that income may have to be returned, or that it may possibly be subject to diminution or off-set will not alone suffice to postpone the accrual and reporting of taxable income. * * *"

We then referred to *Helvering* v. *Nibley-Mimnaugh Lumber Company*, 63 App. D.C. 181, 70 F.2d 843, where

[10] Cert. denied, 326 U.S. 764.

a contract for sale of timberland was executed in 1923 and it was provided that part of the purchase price was paid in cash and the balance thereof by promissory notes secured by a mortgage. The contract further provided that taxpayer should furnish abstracts and that, for certain contingencies as to failures of title and as to there being a smaller amount of timberland than specified in the contract, there should be a reduction in the purchase price. Such reductions, if any, were to be applied against the principal of the notes. We said, at 471 of the *Universal Oil* case:

> "* * * By reason of a shortage in the timberland, determined in 1924, it was agreed between the parties that more than $66,000 of the stated sale price should be deducted from the notes representing the balance of the purchase price. The Court held that if the taxpayer was reporting and paying taxes on an accrual basis, the facts shown were sufficient to accrue the entire purchase price in 1923, even though the agreed price was conditionally subject to abatement. The Court said that the right of the seller to have the notes paid, accrued in 1923, because it then became a fixed and unconditioned liability. It is significant that in that case there was, as here, a condition which provided for a proportionate reduction in the purchase price in the event of the happening of a certain contingency."

Our conclusions, therefore, were:

> "We see from these decisions that it is not every contingency that prevents the accrual of income. The contingency must be real and substantial. * * *
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> "* * * We must, therefore, hold that it was the duty of plaintiff to accrue and report as a part of its

1945 income the total amount of $1,035,205, which it was to receive as its share of the consideration for the license."

To the same effect are *Commissioner of Internal Revenue* v. *Union Pac. R. Co.*, 86 F.2d 637, 639; *Frost Lumber Industries* v. *Commissioner of Int. Rev.*, 128 F.2d 693, 696; and *Clark* v. *Woodward Construction Co.*, 179 F.2d 176, where the court, at 177, said: "The decisive factor is the creation of an enforceable liability."

In the case at bar, each sale was a transaction solely between the purchaser and the partnership. They agreed on the terms of sale, including the selling price, the down payment, the trade-in allowance, and the terms for deferred payments. The purchaser made his down payment to the partnership and delivered his traded-in vehicle to it, together with the executed retail papers. The purchaser went his way and the partnership kept the down payment and the traded-in vehicle. It was the decision of the partnership as to which finance company it would offer the retail paper. It had complete freedom of choice in this regard and conversely each finance company was free to take or refuse the offered paper. Transfer of the paper to a finance company resulted in the partnership receiving the balance of the purchase price, minus the withheld portion, the year of taxability of which is now the subject of this litigation. When this reserve had served its purpose, the partnership would also receive what remained in that fund.

Since the partnership used the accrual method of accounting, its entire profit from the sale should be reported when it accrued, regardless of when received.

Taxpayers contend that the partnership's "right to the amounts withheld from the purchase price of notes was so contingent during the taxable period that such amounts should not be accrued as taxable income in

the years withheld by the finance companies." While it is possible that the partnership would not receive all of the amounts in cash, the parts withheld would in all events be used for the benefit of the partnership to satisfy its future obligations, if any, to the finance companies. Taxpayers confuse the arrangement with respect to *payment* of the sums in the reserve accounts with the vesting in the partnership in the relevant years of a fixed right to receive in due course definite sums which had become accruable to it at the times of sale in the relevant years. There is no uncertainty with respect to the amounts accrued during the relevant years. These amounts were definitely fixed at the time the funds were placed to the partnership's credit in the dealer's reserve accounts. Moreover, there is no showing that the amounts in the reserve accounts would not be collectible at the appropriate time or that collection would be improbable, as we have pointed out, *ante* 5. In the light of the record, it cannot logically be argued that the reserve would never be realized by the partnership.

In its reply brief, the partnership, for the first time, argues that it could have obtained the benefits of reporting its income under the installment method, if it had been financially able to hold the retail paper instead of selling it to finance companies. Evidently referring to 26 U.S.C.A. § 44(a), it argues that an accrual basis taxpayer is entitled to report his installment sale profit in the taxable years that payments are actually recived. However, there is no showing by taxpayers that the partnership purported, in making its returns of income, to rely on § 44(a). Apparently the argument comes as an afterthought. It is not convincing.

Taxpayers have also called our attention to *Johnson* v. *Commissioner*, 233 F.2d 952, *Texas Trailercoach, Inc.* v. *Commissioner*, 251 F.2d 395, and *Glover* v. *Commissioner*, 253 F.2d 735. Even if we ignore some of the

facts involved in these cases which are different from those involved in the case at bar, we adhere to the views herein expressed.

We affirm the decisions of the Tax Court.

AFFIRMED.

A true Copy:

Teste:

____, ____.

Clerk of the United States Court of Appeals for the Seventh Circuit.

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